DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS: 99-0438SLOF
Indiana Corporate Income Tax
For the Tax Years 1989 through 1996

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ISSUES

I. **Income Received from the Sale of Pharmaceutical Division – Business / Nonbusiness Income** - Adjusted Gross Income Tax.

Authority: IC 6-3-1-20; IC 6-3-1-21; IC 6-3-2-2(b); IC 6-3-2-2(g) to (k); Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); F.W. Woolworth v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Exxon Corp. v. Dep't. of Revenue of Wisconsin, 447 U.S. 207 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651 (Ind. Tax Ct. 2001); Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; Ind. R. App. P. 65D; Chief Industries v. Indiana Dept. of Revenue, 2000 Ind. Tax LEXIS 42 (Ind. Tax Ct. Oct. 24, 2000).

Taxpayer argues that the audit erred in classifying money it received from the sale of a pharmaceutical company as "business income." According to taxpayer, the Department of Revenue (Department) compounded that error by sustaining the audit's determination in the original Letter of Findings.

II. **Losses From Contingent Value Rights – Business / Nonbusiness Income** – Adjusted Gross Income Tax.

Authority: I.R.C. § 1001 et seq.; 72 Wash. U. L.Q. 1231 (1994).

Taxpayer argues that the audit erred by inconsistently categorizing losses attributable to Contingent Value Rights as business income during certain years and non-business income during other years.

III. **Computational Errors**.

Authority: IC 6-8.1-5-1(b).

Taxpayer maintains that the audit made numerous computational errors and that these errors resulted in the incorrect assessment of additional corporate income taxes.

STATEMENT OF FACTS

Taxpayer describes itself as being in the chemical business. Taxpayer sells these chemicals to manufacturers as raw materials. An audit was conducted of taxpayer's business records resulting in a proposed adjustment of Indiana corporate income tax liability. Taxpayer disagreed with the proposed adjustments and submitted a protest. An administrative hearing was held, and a Letter of Findings was issued in which taxpayer's protest was affirmed in part and denied in part. Believing that the Letter of Findings was – at least in part – erroneous, taxpayer requested a rehearing; this Supplemental Letter of Findings results.

FINDINGS

I. Income Received from the Sale of Pharmaceutical Division – Business / Nonbusiness Income - Adjusted Gross Income Tax.

Taxpayer bought shares of stock in a pharmaceutical company. The number of shares it bought gave taxpayer a controlling interest in the pharmaceutical company. Shortly thereafter, taxpayer combined one of its pre-existing pharmaceutical divisions with the newly acquired pharmaceutical company. Taxpayer retained its interest in the pharmaceutical company for approximately five years. When it sold its interest in the pharmaceutical company in 19XX, it reported the income as "non-business" income. The audit disagreed and reclassified this income as "business" income. The original Letter of Findings agreed with the audit's conclusion.

For purposes of determining a taxpayer's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three factor formula. IC 6-3-2-2(b). In contrast, nonbusiness income is allocated to Indiana or it is allocated to another state. IC 6-3-2-2(g) to (k). Therefore, "whether income is deemed business income or nonbusiness income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer maintains that the money it earned from the sale of the pharmaceutical company was nonbusiness income, and the money should be allocated elsewhere. Both the audit and the original LOF determined that the money was business income subject to apportionment under the state's adjusted gross income tax scheme.

A. Unitary Relationship.

In part, taxpayer arrives at its conclusion – that the income is not subject to apportionment – on the ground that it did not have a "unitary relationship" with the pharmaceutical company; as a result, Indiana is precluded from apportioning the income. Taxpayer states that before Indiana can apportion the income, "it is necessary to [first] determine whether the income results from a unitary business." Taxpayer indicates that it maintained a hands-off relationship with the

pharmaceutical company; there was no centralized management, purchasing, advertising, or any other "controlled interaction" between taxpayer and the pharmaceutical company. According, to taxpayer, the pharmaceutical company was permitted to operate as an independent entity. Taxpayer explains noting that it is "engaged in the manufacture and sale of chemicals and plastics." In contrast, the pharmaceutical company was "engaged in the manufacture and sale of pharmaceutical products . . . which it sold and marketed to doctors, hospitals, and individuals for human consumption." Taxpayer explain that it would have been counterproductive for it maintain anything more than a strictly passive relationship with the pharmaceutical company because it had no experience in that company's business.

Taxpayer emphasizes it did not have a unitary relationship with the pharmaceutical company and that is made clear by the assertion that it permitted the pharmaceutical company to exercise a substantial degree of self-governance during the five-year ownership period. The two companies did not have the same corporate officers or managers. In fact, by the terms of the stock acquisition agreement, taxpayer was precluded from having more than three out of the possible 17 board members during the initial ownership period. Even after that initial period expired, taxpayer maintains that it never exercised actual control over the company but that the two entities operated separately. According to taxpayer, the pharmaceutical company "performed all the functions that one would expect a stand-alone company to perform."

In sum, taxpayer describes itself as a "passive investor" in the pharmaceutical company and that its role in the company was "limited to mere stewardship or oversight of its investment."

The unitary business principle to which taxpayer alludes "allows a state to consider all of a corporate enterprise's income arising from the enterprise's unitary business in calculating that state's apportioned share of income." Hunt Corp. v. Indiana Dept. of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999). For purposes of resolving the unitary group issue, the Supreme Court has developed a three-part test to determine whether a unitary relationship exists between different entities. The test consists of the following factors; common ownership, common management, and common use or operation. Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); F.W. Woolworth v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Exxon Corp. v. Dep't. of Revenue of Wisconsin, 447 U.S. 207 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980).

Plainly, the first part of the test is met because taxpayer acquired a majority ownership interest in the pharmaceutical company. The remaining two parts of the test – common management and common use or operation – are less easily quantifiable. Taxpayer argues that it never had a unitary relationship with the pharmaceutical company and that it permitted the company to retain its own management, administrative structure, and headquarters. According to taxpayer, it simply invested money in the company, allowed that company an entirely independent existence for five years, and only revisited its interest in the company when it became appropriate to divest itself of its majority ownership interest.

Taxpayer's assertion that its relationship with the pharmaceutical company was simply that of a passive investor is somewhat overstated. When taxpayer assumed control over the

pharmaceutical company, it combined one of its pre-existing pharmaceutical divisions within the targeted company. When taxpayer assumed control over the pharmaceutical business, it renamed the target company merging its own corporate identity with that of the target company. At least to the outside world, the pharmaceutical company's original identity was discarded, and the company became clearly identifiable as another of taxpayer's various divisions.

Moreover, taxpayer's assertion that it was engaged in an entirely different business than that of the pharmaceutical company is also somewhat overstated. Taxpayer's assertion that it is engaged simply in "the manufacture and sale of chemicals and plastics" is excessively modest and substantially understates the scope of its business interests. At the time the audit was completed, taxpayer was engaged in the manufacture of household goods, agricultural products, and agriculture chemicals. It was a supplier of more than 2,400 product "families" including performance plastics, performance chemicals, plastics, chemicals, metals, hydrocarbons, and energy. In addition, taxpayer had more than 100 subsidiaries engaged in a wide variety of activities including insurance, management services, telecommunications, engineering, natural gas pipelines, petroleum, construction, coal gasification, electrical generation, and electric transmission. Furthermore, taxpayer has two entirely separate subsidiaries – distinct from the target pharmaceutical company and the successor pharmaceutical division which it combined into the targeted company – which are also in the pharmaceutical business. Taxpayer's description of itself as a simple producer of raw chemicals understates the extent of its business interests.

Taxpayer maintains that there was no common use or management because the pharmaceutical company operated entirely independent of taxpayer. Although taxpayer may have made a business decision to allow the targeted pharmaceutical company to retain a substantial degree of operational independence, once taxpayer acquired ownership of the company, that company shed its individual identity and was incorporated into and became another facet in an enormously complex and multi-faceted business conglomerate. Given the complexity and scale of taxpayer's business operation and the degree to which the pharmaceutical company was subsumed into taxpayer's business operation, the Department concludes that a "unitary" relationship existed between the pharmaceutical company and taxpayer's diverse business operation.

However, even if the taxpayer is correct in its assertion that it did not have a unitary relationship with the pharmaceutical company, the result does not necessarily preclude a determination that the income received from the subsequent sale of the company was nonetheless "business income." As the Supreme Court has stated, "The existence of a unitary relation between payee and payor is one justification for apportionment, but not the only one." Allied-Signal, 504 U.S. at 787. The Court stated that it did not "…establish a general requirement that there be a unitary relation between the payor and payee to justify apportionment…." Id.

B. Indiana Sourcing.

Taxpayer raises an alternative though related argument. Taxpayer maintains that the money received from its sale of the pharmaceutical company was not Indiana source income. Taxpayer cites to Chief Industries v. Indiana Dept. of Revenue, 2000 Ind. Tax LEXIS 42 (Ind. Tax Ct. Oct. 24, 2000) in support of its position. Taxpayer cites to an unpublished case. Taxpayer's reliance

on this case is unwarranted because the Tax Court's unpublished decision has no precedential value. *See* Ind. R. App. P. 65D. In addition, the Department declines the opportunity to attempt to harmonize the decision in Chief Industries concerning Indiana source income with the Tax Court's teachings concerning the business / non-business income distinction.

C. Business / Nonbusiness Income.

The benchmark for determining whether income can be apportioned is the distinction between "business income" and "non-business income." That distinction is defined by the Indiana Code as follows:

> The term "business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operation. IC 6-3-1-20.

"Non-business income," in turn, "means all income other than business income." IC 6-3-1-21. For purposes of calculating an Indiana corporation's adjusted gross income tax liability, business income is apportioned between Indiana and other states using a three-factor formula, while non-business income is allocated to Indiana or another state in which the taxpayer is doing business. May, 749 N.E.2d at 656. In that decision, the Tax Court determined that IC 6-3-1-20 incorporates two tests for determining whether the income is business or non-business: a transactional test and a functional test. Id. at 662-63. Under the transactional test, gains are classified as business income when they are derived from a transaction in which the taxpayer regularly engages. The particular transaction from which the income derives is measured against the frequency and regularity of similar transactions and practices of the taxpayer's business. Id. at 658-59.

Under the functional test, the gain arising from the sale of an asset will be classified as business income if the acquisition, management, and disposition of the property generating income constitutes an integral part of the taxpayer's regular trade or business operations. *See* IC 6-3-1-20.

Department regulations 45 IAC 3.1-1-29 and 45 IAC 3.1-1-30 provide guidance in determining whether income is business or non-business under the transactional test. 45 IAC 3.1-1-29 states in relevant part that, "Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business." 45 IAC 3.1-1-30 provides that, "[f]or purposes of determining whether income is derived from an activity which is in the regular course of the taxpayer's trade or business, the expression 'trade or business' is not limited to the taxpayer's corporate charter purpose of its principal business activity. A taxpayer may be in more than one trade or business, and derive business therefrom depending upon but not limited to some or all of the following:

(1) The nature of the taxpayer's trade or business.

(2) The substantiality of the income derived from the activities and the percentage that income is of the taxpayer's total income for a given tax period.

(3) The frequency, number of continuity of the activities and transactions involved.

(4) The length of time the property producing income was owned by the taxpayer.

(5) The taxpayer's purpose in acquiring and holding the property producing income.

This business / nonbusiness issue arises from the classification of the money taxpayer received from the sale of the pharmaceutical company. Taxpayer asserts that it is in the business of selling chemicals and is not in the business of selling pharmaceutical companies. However, this characterization oversimplifies the nature of taxpayer's business operations. If taxpayer were simply and solely in the business of selling bulk, raw chemicals, taxpayer's argument might have some cogency. However, the scope of taxpayer's business activity is not nearly so limited. Taxpayer is involved in the production and sale of over 2,400 product "families." Taxpayer has more than 100 subsidiaries engaged in an extraordinarily diverse variety of activities. It is apparent that taxpayer's decision to divest itself of its interest in the pharmaceutical company – after maintaining that interest for approximately five years – was not such an unusual transaction entirely outside the scope of taxpayer's normal business operations. Although taxpayer may not be "in the business" of buying and selling drug companies, the acquisition, operation, and ultimate disposition of an independent operating division was not necessarily a "once-in-a-lifetime" occurrence.

The functional test focuses on the property being disposed of by the taxpayer. Id. Specifically, the functional test requires examining the relationship of the property at issue with the business operations of the taxpayer. May, 749 N.E.2d at. 664. In order to satisfy the functional test, the property generating income must have been acquired, managed, and disposed by the taxpayer in a process integral to taxpayer's regular trade or business operations. Id. In May, the Tax Court defined "integral" as "part of or [a] constituent component necessary or integral to complete the whole." Id. at 664-65. The court concluded that petitioner retailer's sale of one of its retailing divisions was not "necessary or essential" to the petitioner's regular trade or business because the sale was executed pursuant to a court order that benefited a competitor and not the petitioner. Id. at 665. In effect, the court determined that because the petitioner was forced to sell the division in order to reduce its competitive advantage, the sale was not integral to the petitioner's own business operations. Id. Therefore, the proceeds from the division's sale were not business income under the functional test. Id.

Taxpayer decided that it was in its interest to acquire the pharmaceutical company and combine one of its existing pharmaceutical divisions with the target company. Taxpayer made a considered and independent business decision that it was in its own best interests to allow the pharmaceutical company to exercise a degree of operational and managerial independence; in part that decision was based on its agreement with the predecessor shareholders to forego exercising the degree of corporate governance it was entitled to exercise by virtue of its majority

ownership interest. Nonetheless, taxpayer's decision to permit the pharmaceutical company a degree of independence was not a decision imposed on taxpayer; the decision was one which taxpayer willingly made. A taxpayer's independent decision to allow one its divisions a degree of self governance – made freely and for its own considered self-interest – may not be the means by which a taxpayer subsequently determines the tax consequences attendant upon the ultimate disposition of that asset. In taxpayer's own case, it may be reasonably presumed that the 1995 sale of the pharmaceutical company was based upon taxpayer's consideration of its global operational, financial, and corporate needs. The 19XX sale was not dictated by an outside entity. It was not a decision dictated by happenstance or whim. The decisions to purchase the pharmaceutical company, permit that company a degree of self-governance, hold the company for five years, and eventually dispose of the asset were entirely integral to taxpayer's overall business needs.

Under both the transactional and the functional test, the money received from the 19XX sale of the pharmaceutical company was clearly "business income" subject to apportionment under this state's adjusted gross income tax laws.

FINDING

Taxpayer's protest is respectfully denied.

II. **Losses From Contingent Value Rights – Business / Nonbusiness Income** – Adjusted Gross Income Tax.

When taxpayer bought controlling interest in the pharmaceutical company, it issued Contingent Value Rights (CVRs) to the previous shareholders. The CVRs were issued to the former shareholders as a partial purchase price for the interest that taxpayer acquired in the pharmaceutical company. As the issuer of the CVRs, taxpayer "promise[d] to pay the holder the difference between a stated target price and the market price at a specified exercise date (or the average price over a specified period." Alexander J. Triantis & George G. Triantis, Conversion Rights and the Design of Financial Contracts, 72 Wash. U. L.Q. 1231, 1255 n.36 (1994). The CVRs were partial consideration granting the holder of the CVR a degree of price protection against a decline in the value of the stock.

Taxpayer maintains that it experienced annual "losses" attributable to the CVRs. According to taxpayer, the audit classified these "losses" as business income during certain years and as non-business income during other years. Taxpayer maintains that if Indiana determines that the money it received from the sale of the pharmaceutical company was "business income," then the Department should treat the losses attributable to the CVRs in the same manner.

The Department concludes that payments taxpayer expended pursuant to its obligations under the CVRs were not losses. The CVRs represented a collective contingency obligation which would potentially – as is the case here – increase the cost taxpayer incurred in acquiring the pharmaceutical company. The fact that taxpayer entered into a purchase agreement whereby the final purchase price was subject to certain defined variables, does not render any portion of aggregate cost for the pharmaceutical company into a "loss." The question of whether these

yearly payments were "business" or "nonbusiness" losses is irrelevant. Taxpayer may be entitled to adjust the "basis" of the property it acquired; it is not entitled to claim any portion of that adjusted basis as a loss for years in which that adjustment occurred. *See* I.R.C. § 1001 et seq.

FINDING

Taxpayer's protest is respectfully denied.

III. Computational Errors.

Taxpayer maintains that the audit made numerous computational errors and these errors resulted in an additional, unwarranted assessment of corporate income taxes. For example, taxpayer asserts that the audit failed to carry forward a net capital loss incurred in 19SS to 19XX. As an additional example, taxpayer claims that it discovered an error regarding the 19UU foreign dividend deduction assessment.

IC 6-8.1-5-1(b) states that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The administrative hearing process is not the means by which the purported computational errors may be analyzed, corrected, or refuted. Nonetheless, taxpayer has met its burden under IC 6-8.1-5-1(b) of demonstrating that its numerous assertions are neither frivolous nor entirely groundless. Accordingly, the audit division is requested to undertake a supplemental review of the specific claimed errors and make whatever corrections it deems appropriate.

FINDING

Subject to the results of the supplemental audit review, taxpayer's protest is sustained.

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